Statement of
Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation
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Chairman Frank, Ranking Member Bachus and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the importance of reforming our financial regulatory system. The issues under discussion today rival in importance those before the Congress in the wake of the Great Depression.

The proposals put forth by the Administration regarding the structure of the financial system, the supervision of financial entities, the protection of consumers, and the resolution of organizations that pose a systemic risk to the economy provide a useful framework for discussion of areas in vital need of reform. However, these are complex issues that can be addressed in a number of different ways. We all agree that we must get this right and enact regulatory reforms that address the fundamental causes of the current crisis within a carefully constructed framework that guards against future crises.

It is clear that one of these causes was the presence of significant regulatory gaps within the financial system. Differences in the regulation of capital, leverage, complex financial instruments, and consumer protection provided an environment in which regulatory arbitrage became rampant. Reforms are urgently needed to close these regulatory gaps.

At the same time, we must recognize that much of the risk in recent years was built up, within and around, financial firms that were already subject to extensive regulation and prudential supervision. One of the lessons of the past several years is that regulation and prudential supervision alone are not sufficient to control risk-taking within a dynamic and complex financial system. Robust and credible mechanisms to ensure that market participants will actively monitor and control risk-taking must be in place.

We must find ways to impose greater market discipline on systemically important institutions. In a properly functioning market economy there will be winners and losers, and when firms -- through their own mismanagement and excessive risk taking – are no longer viable, they should fail. Actions that prevent firms from failing ultimately distort market mechanisms, including the market's incentive to monitor the actions of similarly situated firms. Unfortunately, the actions taken during the past year have reinforced the idea that some financial organizations are too big to fail. The solution must involve a practical, effective and highly credible mechanism for the orderly resolution of these institutions similar to that which exists for FDIC-insured banks. In short, we need an end to too big to fail.

The notion of too big to fail creates a vicious circle that needs to be broken. Large firms are able to raise huge amounts of debt and equity and are given access to the credit markets at favorable terms without consideration of the firms' risk profile. Investors and creditors believe their exposure is minimal since they also believe the government will not allow these firms to fail. The large firms leverage these funds and become even larger, which makes investors and creditors more complacent and more likely to extend credit and funds without fear of losses. In some respects, investors, creditors, and the firms themselves are making a bet that they are immune from the risks of failure and loss because they have become too big, believing that regulators will avoid taking action for fear of the repercussions on the broader market and economy.

If anything is to be learned from this financial crisis, it is that market discipline must be more than a philosophy to ward off appropriate regulation during good times. It must be enforced during difficult times. Given this, we need to develop a resolution regime that provides for the orderly wind-down of large, systemically important financial firms, without imposing large costs to the taxpayers. In contrast to the current situation, this new regime would not focus on propping up the current firm and its management. Instead, under the proposed authority, the resolution would concentrate on maintaining the liquidity and key activities of the organization so that the entity can be resolved in an orderly fashion without disrupting the functioning of the financial system. Losses would be borne by the stockholders and bondholders of the holding company, and senior management would be replaced. Without a new comprehensive resolution regime, we will be forced to repeat the costly, ad hoc responses of the last year.

My testimony discusses ways to address and improve the supervision of systemically important institutions and the identification of issues that pose risks to the financial system. The new structure should address such issues as the industry's excessive leverage, inadequate capital and over-reliance on short-term funding. In addition, the regulatory structure should ensure real corporate separateness and the separation of the bank's management, employees and systems from those affiliates. Risky activities, such as proprietary and hedge fund trading, should be kept outside of insured banks and subject to enhanced capital requirements.

Although regulatory gaps clearly need to be addressed, supervisory changes alone are not enough to address these problems. Accordingly, policymakers should focus on the elements necessary to create a credible resolution regime that can effectively address the resolution of financial institutions regardless of their size or complexity and assure that shareholders and creditors absorb losses before the government. This mechanism is at the heart of our proposals -- a bank and bank holding company resolution facility that will impose losses on shareholders and unsecured debt investors, while maintaining financial market stability and minimizing systemic consequences for the national and international economy. The credibility of this resolution mechanism would be further enhanced by the requirement that each bank holding company with subsidiaries engaged in non-banking financial activities would be required to have, under rules established by the FDIC, a resolution plan that would be annually updated and published for the benefit of market participants and other customers.

The combined enhanced supervision and unequivocal prospect of an orderly resolution will go a long way to assuring that the problems of the last several years are not repeated and that any problems that do arise can be handled without cost to the taxpayer.

Finally, I will discuss our support for the establishment of a new consumer protection agency for financial products. I also will recommend changes to assure appropriate recognition of the relationship between the safety and soundness of insured banks and their consumer practices in both the structure of the new agency, as well as its role in examination and enforcement.

Improving Supervision and Regulation

The widespread economic damage that has occurred over the past two years has called into question the fundamental assumptions regarding financial institutions and their supervision that have directed our regulatory efforts for decades. The unprecedented size and complexity of many of today's financial institutions raise serious issues regarding whether they can be properly managed and effectively supervised through existing mechanisms and techniques. Our current system clearly failed in many instances to manage risk properly and to provide stability. Many of the systemically significant entities that have needed federal assistance were already subject to extensive federal supervision. For various reasons, these powers were not used effectively and, as a consequence, supervision was not sufficiently proactive.

Insufficient attention was paid to the adequacy of complex institutions' risk management capabilities. Too much reliance was placed on mathematical models to drive risk management decisions. Notwithstanding the lessons from Enron, off-balance sheet-vehicles were permitted beyond the reach of prudential regulation, including holding company capital requirements. The failure to ensure that financial products were appropriate and sustainable for consumers caused significant problems not only for those consumers but for the safety and soundness of financial institutions. Lax lending standards employed by lightly regulated non-bank mortgage originators initiated a downward competitive spiral which led to pervasive issuance of unsustainable mortgages. Ratings agencies freely assigned AAA credit ratings to the senior tranches of mortgage securitizations without doing fundamental analysis of underlying loan quality. Trillions of dollars in complex derivative instruments were written to hedge risks associated with mortgage backed securities and other exposures. This market was, by and large, excluded from federal regulation by statute.

A strong case can be made for creating incentives that reduce the size and complexity of financial institutions. A financial system characterized by a handful of giant institutions with global reach and a single regulator is making a huge bet on the performance of those banks and that regulator.

Financial firms that pose systemic risks should be subject to regulatory and economic incentives that require these institutions to hold larger capital and liquidity buffers to mirror the heightened risk they pose to the financial system. In addition, restrictions on leverage and the imposition of risk-based premiums on institutions and their activities would act as disincentives to growth and complexity that raise systemic concerns. In contrast to the standards implied in the Basel II Accord, systemically important firms should face additional capital charges based on both their size and complexity. To address pro-cyclicality, the capital standards should provide for higher capital buffers that increase during expansions and are available to be drawn down during contractions. In addition, these firms should be subject to higher Prompt Corrective Action standards under U.S. laws and holding company capital requirements that are no less stringent than those applicable to insured banks. Regulators also should take into account off-balance-sheet assets and conduits as if these risks were on-balance-sheet.

The Need for a Financial Services Oversight Council

The significant size and growth of unsupervised financial activities outside the traditional banking system -- in what is termed the shadow financial system -- has made it all the more difficult for regulators or market participants to understand the real dynamics of either bank credit markets or public capital markets. The existence of one regulatory framework for insured institutions and a much less effective regulatory scheme for non-bank entities created the conditions for arbitrage that permitted the development of risky and harmful products and services outside regulated entities.

A distinction should be drawn between the direct supervision of systemically-significant financial firms and the macro-prudential oversight and regulation of developing risks that may pose systemic risks to the U.S. financial system. The former appropriately calls for the identification of a prudential supervisor for any potential systemically significant entity. Entities that are already subject to a prudential supervisor, such as insured depository institutions and financial holding companies, should retain those supervisory relationships.

The macro-prudential oversight of system-wide risks requires the integration of insights from a number of different regulatory perspectives -- banks, securities firms, holding companies, and perhaps others. Only through these differing perspectives can there be a holistic view of developing risks to our system. As a result, for this latter role, the FDIC supports the creation of a Council to oversee systemic risk issues, develop needed prudential policies and mitigate developing systemic risks. In addition, for systemic entities not already subject to a federal prudential supervisor, this Council should be empowered to require that they submit to such oversight, presumably as a financial holding company under the Federal Reserve -- without subjecting them to the activities restrictions applicable to these companies.

Supervisors across the financial system failed to identify the systemic nature of the risks before they were realized as widespread industry losses. The performance of the regulatory system in the current crisis underscores the weakness of monitoring systemic risk through the lens of individual financial institutions and argues for the need to assess emerging risks using a system-wide perspective. The Administration's proposal addresses the need for broader-based identification of systemic risks across the economy and improved interagency cooperation through the establishment of a new Financial Services Oversight Council. The Oversight Council described in the Administration's proposal currently lacks sufficient authority to effectively address systemic risks.

In designing the role of the Council, it will be important to preserve the longstanding principle that bank regulation and supervision are best conducted by independent agencies. Careful attention should be given to the establishment of appropriate safeguards to preserve the independence of financial regulation from political influence. The Administration's plan gives the role of Chairman of the Financial Services Oversight Council to the Secretary of the Treasury. To ensure the independence and authority of the Council, consideration should be given to a configuration that would establish the Chairman of the Council as a Presidential appointee, subject to Senate confirmation. This would provide additional independence for the Chairman and enable the Chairman to focus full time on attending to the affairs of the Council and supervising Council staff. Other members on the Council could include, among others, the federal financial institution, securities and commodities regulators. In addition, we would suggest that the Council include an odd number of members in order to avoid deadlocks.

The Council should complement existing regulatory authorities by bringing a macro-prudential perspective to regulation and being able to set or harmonize prudential standards to address systemic risk. Drawing on the expertise of the federal regulators, the Oversight Council should have broad authority and responsibility for identifying institutions, products, practices, services and markets that create potential systemic risks, implementing actions to address those risks, ensuring effective information flow, and completing analyses and making recommendations. In order to do its job, the Council needs the authority to obtain any information requested from systemically important entities.

The crisis has clearly revealed that regulatory gaps, or significant differences in regulation across financial services firms, can encourage regulatory arbitrage. Accordingly, a primary responsibility of the Council should be to harmonize prudential regulatory standards for financial institutions, products and practices to assure that market participants cannot arbitrage regulatory standards in ways that pose systemic risk. The Council should evaluate differing capital standards which apply to commercial banks, investment banks, and investment funds to determine the extent to which differing standards circumvent regulatory efforts to contain excess leverage in the system. The Council could also undertake the harmonization of capital and margin requirements applicable to all OTC derivatives activities -- and facilitate interagency efforts to encourage greater standardization and transparency of derivatives activities and the migration of these activities onto exchanges or Central Counterparties.

The Council also could consider requiring financial companies to issue contingent debt instruments -- for example, long-term debt that, while not counting towards the satisfaction of regulatory capital requirements, automatically converts to equity under specific conditions. Conditions triggering conversion could include the financial companies' capital falling below prompt corrective action mandated capital levels or regulators declaring a systemic emergency. Financial companies also could be required to issue a portion of their short-term debt in the form of debt instruments that similarly automatically convert to long-term debt under specific conditions, perhaps tied to liquidity. Conversion of long-term debt to equity would immediately recapitalize banks in capital difficulty. Conversion of short-term debt to long-term debt would ameliorate liquidity problems.

Also, the Council should be able to harmonize rules regarding systemic risks to serve as a floor that could be met or exceeded, as appropriate, by the primary prudential regulator. Primary regulators would be charged with enforcing the requirements set by the Council. However, if the primary regulators fail to act, the Council should have the authority to do so. The standards set by the Council should be designed to provide incentives to reduce or eliminate potential systemic risks created by the size or complexity of individual entities, concentrations of risk or market practices, and other interconnections between entities and markets. Any standards set by the Council should be construed as a minimum floor for regulation that can be exceeded, as appropriate, by the primary prudential regulator.

The Council should have the authority to consult with systemic and financial regulators from other countries in developing reporting requirements and in identifying potential systemic risk in the global financial market. The Council also should report to Congress annually about its efforts, identify emerging systemic risk issues and recommend any legislative authority needed to mitigate systemic risk.

Some have suggested that a council approach would be less effective than having this authority vested in a single agency because of the perception that a deliberative council such as this would need additional time to address emergency situations that might arise from time to time. Certainly, some additional thought and effort will be needed to address any dissenting views in council deliberations. However, a Council with regulatory agency participation will provide for an appropriate system of checks and balances to ensure that decisions reflect the various interests of public and private stakeholders. In this regard, it should be noted that the board structure at the FDIC, with the participation of the Comptroller of the Currency and the Director of the Office of Thrift Supervision, is not very different from the way the Council would operate. In the case of the FDIC, quick decisions have been made with respect to systemic issues and emergency bank resolutions on many occasions. Based on our experience with a board structure, we believe that decisions could be made quickly by a deliberative council.

Resolution Authority

Even if risk-management practices improve dramatically and we introduce effective macro-prudential supervision, the odds are that a large systemically significant firm will become troubled or fail at some time in the future. The current crisis has clearly demonstrated the need for a single resolution mechanism for financial firms that will preserve stability while imposing the losses on shareholders and creditors and replacing senior management to encourage market discipline. A timely, orderly resolution process that could be applied to both banks and non-bank financial institutions, and their holding companies, would prevent instability and contagion and promote fairness. It would enable the financial markets to continue to function smoothly, while providing for an orderly transfer or unwinding of the firm's operations. The resolution process would ensure that there is the necessary liquidity to complete transactions that are in process at the time of failure, thus addressing the potential for systemic risk without creating the expectation of a bailout.

Under the new resolution regime, Congress should raise the bar higher than existing law and eliminate the possibility of open assistance for individual failing entities. The new resolution powers should result in the shareholders and unsecured creditors taking losses prior to the government, and consideration also should be given to imposing some haircut on secured creditors to promote market discipline and limit costs potentially borne by the government.

Limitations of the current resolution authority

The FDIC's resolution powers are very effective for most failed bank situations (see Appendix). However, systemic financial organizations present additional issues that may complicate the FDIC's process of conducting an efficient and economical resolution. As noted above, many financial activities today take place in financial firms that are outside the insured depository institution where the FDIC's existing authority does not reach. These financial firms must be resolved through the bankruptcy process, as the FDIC's resolution powers only apply to insured depository institutions. Resolving large complex financial firms through the bankruptcy process can be destabilizing to regional, national and international economies since the timing is uncertain and the process can be complex and protracted and may vary by jurisdiction.

By contrast, the powers that are available to the FDIC under its statutory resolution authorities can resolve financial entities much more rapidly than under bankruptcy. The FDIC bears the unique responsibility for resolving failed depository institutions and is therefore able to plan for an orderly resolution process. Through this process, the FDIC works with the primary supervisor to gather information on a troubled bank before it fails and plans for the transfer or orderly wind-down of the bank's assets and businesses. In doing so, the FDIC is able to maintain public confidence and perform its public policy mandate of ensuring financial stability.

Resolution authority for systemically important financial firms

To ensure an orderly and comprehensive resolution mechanism for systemically important financial firms, Congress should adopt a resolution process that adheres to the following principles:

- The resolution scheme and processes should be transparent, including the imposition of losses according to an established claims priority where stockholders and creditors, not the government, are in the first loss position.

- The resolution process should seek to minimize costs and maximize recoveries. The resolution should be conducted to achieve the least cost to the government as a whole with the FDIC allocating the losses among the various affiliates and subsidiaries proportionate to their responsibilities for the cost of the failure.

- There should be a unified resolution process housed in a single entity.

- The resolution entity should have the responsibility and the authority to set assessments to fund systemic resolutions to cover working capital and unanticipated losses.

- The resolution process should allow the continuation of any systemically significant operations, but only as a means to achieve a final resolution of the entity. A bridge mechanism, applicable to the parent company and all affiliated entities, allows the government to preserve systemically significant functions. It enables losses to be imposed on market players who should appropriately bear the risk. It also creates the possibility of multiple bidders for the financial organization and its assets, which can reduce losses to the receivership.

- The resolution entity must effectively manage its financial and operational risk exposure on an on-going basis. The receivership function necessarily entails certain activities such as the establishment of bridge entities, implementing purchase and assumption agreements, claims processing, asset liquidation or disposition and franchise marketing. The resolving entity must establish, maintain and implement these functions for a covered parent company and all affiliated entities.

Financial firms often operate on a day-to-day basis without regard to the legal structure of the firm. That is, employees of the holding company may provide vital services to a subsidiary bank because the same function exists in both the bank and the holding company. However, this intertwining of functions can present significant issues when trying to wind down the firm. For this reason, there should be requirements that mandate greater functional autonomy of holding company affiliates.

In addition, to facilitate the resolution process, the holding companies should have an acceptable resolution plan that could facilitate and guide the resolution in the event of a failure. Through a carefully considered rulemaking, each financial holding company should be required to make conforming changes to their organization to ensure that the resolution plans could be effectively implemented. The plans should be updated annually and made publicly available.

Congress also should alter the current process that establishes a procedure for open bank assistance that benefits shareholders and eliminates the requirement that the resolution option be the least costly to the Deposit Insurance Fund (DIF). As stated above, shareholders and creditors should be required to absorb losses from the institution's failure before the government.

Current law allows for an exception to the standard claims priority where the failure of one or more institutions presents "systemic risk." In other words, once a systemic risk determination is made, the law permits the government to provide assistance irrespective of the least cost requirement, including "open bank" assistance which inures to the benefit of shareholders. The systemic risk exception is an extraordinary procedure, requiring the approval of super majorities of the FDIC Board, the Federal Reserve Board, and the Secretary of the Treasury in consultation with the President.

We believe that the systemic risk exception should be narrowed so that it is available only where there is a finding that support for open institutions is necessary to address problems which pervade the system, as opposed to problems which are particular to an individual institution. Whatever support is provided should be broadly available and justified in that it will result in least cost to the government as a whole. If the government suffers a loss as a result an institution's performance under this exception, the institution should be required to be resolved in accordance with the standard claims priority.

Had this narrower systemic risk exception been in place during the past year, open institution assistance would not have been permitted for individual institutions. An individual institution would likely have been put into a bridge entity, with shareholders and unsecured creditors taking losses before the government. Broader programs that benefit the entire system, such as the Temporary Liquidity Guarantee Program and the Federal Reserve's liquidity facilities, would have been permitted. However if any individual institution participating in these programs had caused a loss, the normal resolution process would be triggered.

The initiation of this type of systemic assistance should require the same concurrence of the supermajority of the FDIC Board, the Federal Reserve Board and the Treasury Department (in consultation with the President) as under current law. No single government entity should be able to unilaterally trigger a resolution strategy outside the defined parameters of the established resolution process. Further, to ensure transparency, these determinations should be made in consultation with Congress, documented and reviewed by the Government Accountability Office.

Other improvements to the resolution process

Consideration should be given to allowing the resolution authority to impose limits on financial institutions' abilities to use collateral to mitigate credit risk ahead of the government for some types of activities. The ability to fully collateralize credit risks removes an institution's incentive to underwrite exposures by assessing a counterparty's ability to perform from revenues from continuing operations. In addition, the recent crisis has demonstrated that collateral calls generate liquidity pressures that can magnify systemic risks. For example, up to 20 percent of the secured claim for companies with derivatives claims against the failed firm could be haircut if the government is expected to suffer losses. This would ensure that market participants always have an interest in monitoring the financial health of their counterparties. It also would limit the sudden demand for more collateral because the protection could be capped and also help to protect the government from losses. Other approaches could include increasing regulatory and supervisory disincentives for excessive reliance on secured borrowing.

As emphasized at the beginning of this statement, a regulatory and resolution structure should, among other things, ensure real corporate separateness and the separation of the bank's management, employees, and systems from those of its affiliates. Risky activities, such as proprietary trading, should be kept outside the bank. Consideration also should be given to enhancing restrictions against transactions with affiliates, including the elimination of 23A waivers. In addition, the resolution process could be greatly enhanced if companies were required to have an acceptable resolution plan that and guides the liquidation in the event of a failure. Requiring that the plans be updated annually and made publicly available would provide additional transparency that would improve market discipline.

Funding Systemic Resolutions

To be credible, a resolution process for systemically significant institutions must have the funds necessary to accomplish the resolution. It is important that funding for this resolution process be provided by the set of potentially systemically significant financial firms, rather than by the taxpayer. To that end, Congress should establish a Financial Company Resolution Fund (FCRF) to provide working capital and cover unanticipated losses for the resolution.

One option for funding the FCRF is to pre-fund it through a levy on larger financial firms -- those with assets above a certain large threshold. The advantage of pre-funding the FCRF is the ability to impose risk-based assessments on large or complex institutions that recognize their potential risks to the financial system. This system also could provide an economic incentive for an institution not to grow too large. In addition, building the fund over time through consistent levies would avoid large procyclical charges during times of systemic stress.

Alternatively, the FCRF could be funded after a systemic failure through an assessment on other large, complex institutions. The advantage to this approach is that it does not take capital out of institutions until there is an actual systemic failure. The disadvantages of this approach are that it is not risk sensitive, it is initially dependent on the ability to borrow from the Treasury, it assess institutions when they can least afford it and the institution causing the loss is the only one that never pays an assessment.

The systemic resolution entity should have the authorities needed to manage this resolution fund, as the FDIC does for the DIF. The entity should also be authorized to borrow from the Treasury if necessary, but those borrowings should be repaid by the financial firms that contribute to the FCRF.

International issues

Some significant challenges exist for international banking resolution actions since existing bank crisis management and resolution arrangements are not designed to deal specifically with cross-border banking problems. However, providing resolution authority to a specific entity in the U.S. would enhance the ability to enter into definitive memoranda of understanding with other countries. Many of these same countries have recognized the benefits of improving their resolution regimes and are considering improvements. This provides a unique opportunity for the U.S. to be the leader in this area and provide a model for the effective resolution of failed entities.

Dealing with cross-border banking problems is difficult. For example, provisions to allow the transfer of assets and liabilities to a bridge bank or other institution may have limited effectiveness in a cross-border context because these actions will not necessarily be recognized or promptly implemented in other jurisdictions. In the absence of other arrangements, it is presumed that ring fencing will occur. Ring fencing may secure the interests of creditors or individuals in foreign jurisdictions to the detriment of the resolution as a whole.

In the United States, the Foreign Bank Supervision Enhancement Act of 1991 requires foreign banks that wish to do a retail deposit-taking business to establish a separately chartered subsidiary bank. This structural arrangement ensures that assets and capital will be available to U.S. depositors or the FDIC should the foreign parent bank and its U.S. subsidiary experience difficulties. In this sense, it is equivalent to "pre-packaged" ring fencing. An idea to consider would be to have U.S. banks operating abroad to do so through bank subsidiaries. This could streamline the FDIC's resolution process for a U.S. bank with foreign operations. U.S. operations would be resolved by the FDIC and the foreign operations by the appropriate foreign regulator. However, this would be a major change and could affect the ability of U.S. banks to attract foreign deposits overseas.

Resolution Authority for Depository Institution Holding Companies

To have a process that not only maintains liquidity in the financial system but also terminates stockholders' rights, it is important that the FDIC have the authority to resolve both systemically important and non-systemically important depository institution holding companies, affiliates and majority-owned subsidiaries in the case of failed or failing insured depository institutions. When a failing bank is part of a large, complex holding company, many of the services essential for the bank's operation may reside in other portions of the holding company, beyond the FDIC's authority. The loss of essential services can make it difficult to preserve the value of a failed institution's assets, operate the bank or resolve it efficiently. The business operations of large, systemic financial organizations are intertwined with business lines that may span several legal entities. When one entity is in the FDIC's control while the other is not, it significantly complicates resolution efforts. Unifying the holding company and the failed institution under the same resolution authority can preserve value, reduce costs and provide stability through an effective resolution. Congress should enhance the authority of the FDIC to resolve the entire organization in order to achieve a more orderly and comprehensive resolution consistent with the least cost to the DIF.

When the holding company structure is less complex, the FDIC may be able to effect a least cost resolution without taking over the holding company. In cases where the holding company is not critical to the operations of the bank or thrift, the FDIC should be able to opt out -- that is, allow the holding company to be resolved through the bankruptcy process. The decision on whether to employ enhanced resolution powers or allow the bank holding company to declare bankruptcy would depend on which strategy would result in the least cost to the DIF. Enhanced authorities that allow the FDIC to efficiently resolve failed depository institutions that are part of a complex holding company structure when it achieves the least costly resolution will provide immediate efficiencies in bank resolutions.

Consumer Protection

Many of the current problems affecting the safety and soundness of the financial system were caused by a lack of strong, comprehensive rules against abusive lending practices applying to both banks and non-banks, and lack of a meaningful examination and enforcement presence in the non-bank sector. Products and practices that strip individual and family wealth undermine the foundation of the economy. As the current crisis demonstrates, increasingly complex financial products combined with frequently opaque marketing and disclosure practices result in problems, not just for consumers, but for institutions and investors as well. As the ultimate insurer of over $6 trillion in deposits, the FDIC has both the responsibility and vital need to ensure that consumer compliance and safety and soundness are appropriately integrated.

To protect consumers from potentially harmful financial products, the Administration has proposed to establish a single primary federal consumer-products regulator, the Consumer Financial Protection Agency (CFPA). The CFPA would regulate providers of consumer credit, savings, payment and other financial products and services. Under the proposal, the agency would be the sole rule-making authority for consumer financial protection statutes and would have supervisory and enforcement authority over all providers of consumer credit. It would set a floor on consumer regulation and supervision and would guarantee the ability of states to adopt and enforce stricter laws for institutions of all types, regardless of charter.

The proposal would eliminate regulatory gaps between insured depository institutions and non-bank providers of financial products and services by establishing strong, consistent consumer protection standards across the board. It also would address another gap by giving the CFPA authority to examine non-bank financial service providers that are not currently examined by the federal banking agencies. In addition, the Administration's proposal would eliminate the potential for regulatory arbitrage that exists because of federal preemption of certain State laws. By creating a floor for consumer protection and by allowing more protective State consumer laws to apply to all providers of financial products and services operating within a State, the CFPA should significantly improve consumer protection.

The Administration's proposal could be made even more effective with a few targeted, but critical changes, which would strengthen oversight for all financial service providers, as well as assure no disruption in consumer compliance oversight of banks. As the banking regulators' experience over the past few years has graphically illustrated, consumer protection issues and the safety and soundness of insured institutions go hand-in-hand. There is a direct correlation between effective consumer compliance programs and safe and sound institutions. Examination and supervision for safety and soundness and consumer protection need to be closely coordinated and reflect a comprehensive understanding of institutions' management, operations, policies, and practices, and the bank supervisory process as a whole. Consumer protection and risk supervision both benefit from the synergies created by this holistic approach and the ready and timely access to expertise and critical information. Separating consumer protection examination and supervision from those other supervisory efforts could undermine the effectiveness of both, with the unintended consequence of weakening bank oversight.

Also, since most of the problem products and practices that contributed to the current crisis began outside the banking industry, focusing examination and enforcement on the non-bank sector is key to addressing most of the abusive lending practices faced by consumers. For example, a recent Treasury Department report indicated that 94 percent of high cost mortgages were made outside the traditional banking sector.1 However, the Administration proposal does not address the means by which the CFPA will be able to garner the resources or and infrastructure to supervise products and services offered by non-banks. Simply moving the examination and supervision functions from the financial institution regulators to the FCPA will not address the lack of supervision of non-bank entities because the financial institution examiners are already fully engaged with their banking sector institutions. Further, spreading the available resources over both non-banking and banking institutions would only serve to diminish the CFPA's effectiveness overall.

The CFPA should have sole rule-writing authority over consumer financial products and services and the federal banking regulators should be required to examine for and enforce those standards. If the bank regulators are not performing this role properly, the CFPA should retain backup examination and enforcement authority to address any situation where it determines that a banking agency is providing insufficient supervision. By freeing the CFPA from direct supervision and enforcement of depository institutions, the CFPA would be able to focus its examination and enforcement resources on the non-bank financial providers that provide financial products and services that have not previously been subject to federal examination and clear supervisory standards.

Accordingly, the federal banking agencies should retain the authority to examine and supervise insured institutions for both consumer protection compliance and safety and soundness. The CFPA should be given the authority to examine and supervise non-bank consumer product and service providers and back-up enforcement authority over insured depository institutions. Giving the CFPA authority to write rules for all consumer product and service providers would ensure strong and uniform consumer protection standards for all consumer product and service providers.

In addition, as the only federal regulator with exposure to all insured financial institutions, the FDIC should be represented on the CFPA Board. The FDIC is the primary federal supervisor for the largest number of banks (including many larger ones), and maintains an active examination staff on-site in the largest major banks as back up supervisor. The FDIC's direct supervision of the majority of the nation's community banks provides it with a unique perspective and a "Main Street" orientation that resulted in it being an early proponent of affordable and sustainable mortgage loan modifications, improved economic inclusion, and the prevention of abusive lending practices. Moreover, the FDIC's deposit insurance function involves a significant consumer protection role with regard to consumer deposits that affects all institutions, but is unique to the FDIC.

Some have questioned why prudential supervisors should have a position on the CFPA board when the views of the CFPA would not necessarily be reflected in the activities of the prudential supervisor. To address this criticism, the FDIC would support the addition of the CFPA Chairman as a member of our board of directors. The Administration's proposal to merge the two national chartering agencies will create a vacancy on the FDIC Board that could be filled by the CFPA Chairman. This would increase the visibility of consumer protection as a core mission of the FDIC. In addition, this type of reciprocal arrangement could provide benefits for both safety and soundness and consumer protection regulation and supervision.

Conclusion

The current financial crisis demonstrates the need for changes in the supervision and resolution of financial institutions, especially those that are systemically important to the financial system. The FDIC stands ready to work with Congress to ensure that the appropriate steps are taken to strengthen our supervision and regulation of all financial institutions -- especially those that pose a systemic risk to the financial system.

I would be pleased to answer any questions from the Committee.

APPENDIX A

The FDIC's resolution authority

The FDIC has standard procedures that go into effect when an FDIC-insured bank or thrift is in danger of failing. When the FDIC is notified that an insured institution is in danger of failing, we begin assembling an information package for bidders that specifies the structure and terms of the transaction. FDIC staff review the bank's books, contact prospective bidders, and begin the process of auctioning the bank -- usually prior to its failure -- to achieve the best return to the bank's creditors and the Deposit Insurance Fund (DIF).

When the appropriate federal or state banking authority closes an insured depository institution, it appoints the FDIC as conservator or receiver. On the day of closure by the chartering entity, the FDIC takes control of the bank and in most cases removes the failed bank's management. Shareholder control rights are terminated, although shareholders maintain a claim on any residual value remaining after depositors' and other creditors' claims are satisfied.

Most bank failures are resolved by the sale of some or all of the bank's business to an acquiring bank. FDIC staff work with the acquiring bank, and make the transfer as unobtrusive, seamless and efficient as possible. Generally, all the deposits that are transferred to the acquiring bank are made immediately available on-line or through ATMs. The bank usually reopens the next business day with a new name and under the control of the acquiring institution. Those assets of the failed bank that are not taken by the acquiring institution are then liquidated by the FDIC.

Sometimes banks must be closed quickly because of an inability to meet their funding obligations. These "liquidity failures" may require that the FDIC set up a bridge bank. The bridge bank structure allows the FDIC to provide liquidity to continue the bank's operations until the FDIC has time to market and sell the failed bank. The creation of a bridge also terminates stockholders rights as described earlier.

Perhaps the greatest benefit of the FDIC's process is the quick reallocation of resources. It is a process that can be painful to shareholders, creditors and bank employees, but history has shown that early recognition of losses with closure and sale of non-viable institutions is the fastest path back to economic health.

1 Financial Regulatory Reform: A New Foundation, U.S. Department of the Treasury (June 17, 2009), at 69.

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